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FM AMCONSUL SHANGHAI
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INFO RUEHBJ/AMEMBASSY BEIJING 2488
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RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RHMFIUU/DEPT OF JUSTICE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHGZ/AMCONSUL GUANGZHOU 0183
RUEHHK/AMCONSUL HONG KONG 1894
RUEHML/AMEMBASSY MANILA 0050
RUEHUL/AMEMBASSY SEOUL 0362
RUEHGH/AMCONSUL SHANGHAI 8238
RUEHSH/AMCONSUL SHENYANG 1716
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RUEHKO/AMEMBASSY TOKYO 0532

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STATE FOR EAP/CM, DAS DAVIES
TREASURY FOR AMB HOLMER/WRIGHT/TSMITH
TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP/CUSHMAN
TREASURY FOR IMFP -- SOBEL/MOGHTADER
USDOC FOR ITA DAS KASOFF, MELCHER, MAC/OCEA
NSC FOR WILDER/LOI
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
STATE PASS CFTC FOR OIA/GORLICK

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TAGS: CH ECON EFIN KTIA PREL
SUBJECT: (SBU) NEW TAXES HIT FOREIGN FINANCIAL FIRMS

¶1. (SBU) Summary. Foreign banks based in China could see their cost of foreign funding rise by 15 percent this year as a result of recent Chinese tax changes, said a partner in a leading tax accountancy firm's Shanghai office. Foreign banks have lobbied for exemptions, but so far have not been successful. The new tax regulations most likely will put foreign financial institutions at a competitive disadvantage, said our contact, but they are unlikely to sour on the China market and instead will attempt to pass the new costs on to their customers. In addition, Shanghai is quietly offering incentives to attract financial firms to boost Shanghai as China's financial center. Shanghai's tax collectors are more "open minded" than those in second-tier cities, said our contact. End summary.

Beijing Closing Foreign Banks' Tax Loopholes

¶2. (SBU) Foreign banks based in China could see their cost of foreign funding rise by 15 percent this year as a result of recent Chinese tax changes, Deloitte partner Johnny Foon (please protect) told Econoff on February 4, 2009. First, China-based financial institutions now owe a 10 percent withholding tax on the interest paid to overseas lenders. Second, although less certain, China-based financial institutions may be required to pay a 5 percent business tax on the full interest paid to overseas lenders.

¶3. (SBU) Foreign banks over the past year have lobbied Chinese tax authorities to be exempted from the 10 percent withholding tax on interest, but in November 2008 were turned down, said Foon. The withholding tax became a problem for foreign banks with the unification of the corporate income tax code last year, when a previous loophole was closed. (Note: Before January 1, 2008, the average applied corporate income tax rate for foreign-invested companies was 15 percent, and that for domestic firms was 25 percent, according to a People's Daily article.

These rates are now unified at 25 percent. The withholding tax of 10 percent is imposed on cross-border transactions that otherwise would not be subject to corporate income tax. End note.) Following the November decision, corporate taxpayers are liable to pay the withholding tax retroactively to January 1, ¶2008. Localities are currently negotiating with foreign banks and other companies that owe this tax -- Shanghai, for instance, is considering delaying payments until February 19.

¶4. (SBU) As for the 5 percent business tax on interest, to date Chinese tax authorities have not clarified whether China-based financial institutions are liable for the full amount, said Foon. The new business tax implementing regulations were issued in November 2008 and became effective on January 1, 2009, he explained. Under them, foreign banks are probably liable for business tax not just on the net interest (the difference between the lenders' cost of funds and the interest charged to borrowers in China), but on the gross interest, said Foon. Chinese officials will not accept calculations of net interest, because they do not have access to the lenders' accounts to verify the original cost of funds, said Foon.

¶5. (SBU) However, to date, Foon knows of no local tax authorities that are attempting to collect the business tax on a gross interest basis. One bank client informed him that on February 3, the Shanghai tax bureau called informally to ask the bank to pay the business tax; calls by Deloitte to other bank clients revealed that no other banks have yet been contacted to do so, said Foon. Since banks pay business tax on a quarterly basis, it could be that local tax authorities are biding their time on the issue, said Foon.

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New Taxes Disadvantage Foreign Banks . . .
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¶6. (SBU) The new tax regulations most likely will put foreign financial institutions at a competitive disadvantage, said Foon. China-based foreign banks depend heavily on funding from their overseas affiliates, so any increase in the tax rates on funding from overseas will hit foreign banks harder. In Foon's opinion, the 15 percent tax rate (if both taxes are implemented) that foreign banks would pay on the gross interest rate for foreign funds would outweigh the 25 percent corporate income tax that local banks pay on the net interest rate for local funds. In addition, the margins for interbank lending are very tight, so the new taxes could easily outweigh the profits an overseas lender would earn from the transaction.

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. . . But Beijing Calculates Foreign Banks Will Absorb the Costs
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¶9. (SBU) Foon said that Chinese officials have determined that the new taxes will not deter foreign banks from expanding in the China market. In the process of unifying the foreign and domestic corporate income tax rates, Chinese economic officials had studied the issue of how much tax increases foreign firms could bear. They concluded that tax advantages were not the major draw for foreign firms, but rather the promise of the large, rapidly growing domestic market. Foon said that his foreign bank clients intend to defray the burden of the new taxes by passing them on to customers. In addition, foreign lenders may be able to offset the 10 percent withholding tax by claiming it as a deduction in their home tax jurisdiction under double-taxation treaties.

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Tax Incentives under Shanghai's Plan to Become a Financial Center
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¶10. (SBU) Another mitigating factor for foreign financial firms may be incentives offered by Shanghai as it seeks to solidify its position as China's international financial center.

However, Foon explained that Shanghai's plan to offer tax and other incentives to financial firms in order to build up Shanghai as a financial center is complicated by the city's taxation system. Shanghai centralizes all taxation by sector at the municipal level. Therefore, Pudong, where Shanghai's famed Lujiazui financial area is located, does not have the authority to offer tax breaks to financial firms, despite making offers to do so. Financial firms complained about this to the Shanghai Municipal Financial Affairs Office, and this past fall that office quietly began negotiating various incentives on an individual firm basis, said Foon.

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Observations on Shanghai's Tax Authorities
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¶11. (SBU) Shanghai's tax collectors are more "open minded" than those in second-tier cities, said Foon. For instance, Shanghai officials will actively consider the arguments made by Deloitte tax consultants regarding interpretations of the tax code. In the smaller cities, officials are much more focused on revenue targets: if revenues are running above target, companies will be asked to delay tax payments until the following year; if behind target, companies will be subject to hostile audits and large fines.
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